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C O N F I D E N T I A L BUENOS AIRES 000801

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NSC FOR JOSE CARDENAS, ROD HUNTER
PASS FED BOARD OF GOVERNORS FOR KROSZNER, ROBITAILLE
PASS EXIM BANK FOR MICHELE WILKINS
PASS OPIC FOR JOHN SIMON, GEORGE SCHULTZ, RUTH ANN NICASTRI
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER

E.O. 12958: DECL: 11/02/2016

TAGS: [EFIN](#) [ECON](#) [AR](#)

SUBJECT: ARGENTINE CENTRAL BANK PRESIDENT ARGUES CASE FOR
GRADUAL TIGHTENING OF MONETARY POLICY; EXPRESSES CONCERNS
OVER BANCO DEL SUR

REF: A. BUENOS AIRES 550

[1](#)B. 2006 BUENOS AIRES 2486

Classified By: Ambassador E.A. Wayne for Reasons 1.4 (b,d)

Subject

[1](#)1. (C) During an April 18 meeting to discuss the May 15 visit of Federal Reserve Governor Randall Kroszner to Argentina, Central Bank (BCRA) President Martin Redrado asked for Ambassador's help in explaining to Washington that the Argentine economy is still going through a post-crisis transition period, warranting gradual and cautious monetary policy. He argued that the financial sector was still too small (at 11% of GDP) for the BCRA to use interest rate increases to fight inflation efficiently, and instead insisted that restraining current pro-cyclical fiscal policy would have more impact on slowing aggregate demand. Redrado reiterated his concerns about the Banco del Sur (reported Ref A), but also argued that there was a need in South America for large infrastructure project financing. End Summary.

Argument for Gradualist Approach

[1](#)2. (C) During an April 18 meeting to discuss the May 15-16 visit of Federal Reserve Governor Kroszner to Argentina, BCRA President Redrado asked for Ambassador's assistance in explaining his monetary policy vision to Washington. Redrado said he had to do a lot of explaining (and justifying) of BCRA policies during recent IMF/World Bank meetings in Washington and he provided a paper (emailed to State and

Treasury) laying out his justification for the gradualist approach the BCRA is pursuing. The paper's main premise is that Argentina is still in the post-crisis transition phase, and economic variables, i.e., price levels, particularly for nontradables, have not yet reached their equilibrium levels. (Note: Post outlined Redrado's argument for gradualism in detail in Ref B, a report on Charge's October 20, 2006, meeting with Redrado. End Note)

13. (C) Redrado said the main question he received while in Washington was why the BCRA was not raising interest rates (which, in the short term, remain net negative in real terms) to contain inflation. He responded that Argentina's domestic credit markets are still recovering from the crisis and the volume of credits outstanding total only 11% of GDP (vs. about 25% pre-crisis). Therefore, the power of monetary policy (raising/lowering interest rates) to affect the real economy was limited compared to that of tax or fiscal policies, and rate hikes would end up hurting investment rather than reducing consumption.

14. (C) Redrado noted that the consolidated primary fiscal surplus (including provinces) had fallen from 5.2% of GDP in 2004 to 3.8% in 2006, and was estimated at 3.1% for 2007. This pro-cyclical and expansionary (at the margin) fiscal policy had pumped a total of \$6 to 7 billion into aggregate demand and was contributing to higher inflation. He concluded that restraining this expansionary fiscal policy would have more success in reducing inflation than rushing monetary policy's transition to an inflation-targeting regime.

15. (C) The main tenant of Redrado's gradualist approach is limiting the growth of monetary aggregates (the monetary

base) to levels below nominal GDP growth, which Redrado argued was a signal to the market of prudent and cautious monetary policy. He pointed out that BCRA had also doubled nominal rates since 2005 (from 5.5% to over 10%), although he agreed that real rates are still negative by most measures. He argued that the BCRA has also been effective at limiting the exposure of the Central Bank and private financial sector to the federal government, a departure from BCRA behavior during the 1980s and 1990s. (Note: private sector credit to the public sector peaked at over 50% in 2002, and has since fallen to under 20%. End Note)

Fed Governor Kroszner Visit

16. (SBU) Governor Kroszner is visiting Argentina May 15-16 at Redrado's invitation, and as part of a larger trip that includes stops in Brazil and Uruguay. Redrado said he would set up a meeting with prominent economists and the BCRA would also provide a forum for Kroszner to give a speech about current challenges and risks in world financial markets. (Note: Redrado said he had recommended that Kroszner avoid commenting on Argentina-specific issues. End Note) The Ambassador agreed to host a dinner or lunch with prominent business representatives, bankers, and academics, and may also arrange a small press event.

Redrado Critical of Unclear Concept for Banco del Sur

17. (C) Redrado echoed his previous criticisms of the Banco del Sur (Ref A), and noted that little of substance had come of it to date. He said Venezuela had hired a law firm, which had cut and pasted from IMF, IDB, and CAF charters to develop a confusing charter for the Banco del Sur that was "everything to all people." He hoped that President Kirchner and Brazilian President Lula da Silva would begin to "rationalize" the Bank's purpose and goals during their planned April 27 meeting in Buenos Aires.

18. (C) Redrado said it was unclear whether the purpose of the bank was to finance infrastructure, finance value added production chains in South America, or provide a liquidity line (similar to the Fondo Latinoamericano de Reservas, based

in Colombia). The Ambassador, noted Brazil's apparent reluctance to support the bank and commented that many in the Argentine private sector were wondering why it was needed, given high global liquidity levels and other available private sector and international development bank sources of financing. He said he had even heard recently that Argentina had borrowed about \$1.9 billion from Brazil's development bank (BNDS), which seemed to undermine the argument that more sources of financing were needed.

¶9. (C) Redrado agreed, but suggested that an argument could be made for creating a regional bank focused on large infrastructure project finance. He said most existing development banks (not including the IDB) required federal guarantees to support large private-sector projects, and this not only required some kind of Congressional approval or Presidential decree, but also showed up as a contingent liability on government books, thus raising official debt levels. This need for a guarantee blocked many projects, and a regional development bank could potentially avoid or work around such a requirement. Redrado argued that large infrastructure projects were a critical component of the

region's need to increase productivity and enhance its competitiveness with Asia. However, he acknowledged that it had to be done right, and he did not trust Venezuela to manage that.

Comment

¶10. (C) Redrado is in a tough spot. The Central Bank is not a fully independent institution, and Redrado is under orders from the President to maintain a competitive nominal exchange rate through an aggressive sterilization campaign. To accomplish this, he must essentially forego the use of monetary policy to slow the economic growth rate and reduce inflation, because any effort to contract the monetary supply (by raising rates on BCRA short term instruments and reducing the pesos in circulation) would result in a nominal appreciation of the exchange rate.

¶11. (C) As the IMF argued during the recent IMF/World Bank meetings, Argentina should use all macroeconomic tools to slow inflation. This means cutting spending, increasing rates and contracting the money supply, and allowing the peso to appreciate against the dollar, while also keeping a lid on wages. Done in moderation and in coordination, the GoA and BCRA should still be able to reign in inflationary pressures, giving them space to gradually roll back price controls. Unfortunately, there are no indications that President Kirchner has any intention of pursuing this course of action, either prior to or even after the October 2007 elections.
End Comment.

WAYNE